

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
FINANCIAL AUDIT REPORT
YEARS ENDED JUNE 30, 1986 AND 1987

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

F-740

CALIFORNIA STUDENT AID COMMISSION
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FINANCIAL AUDIT REPORT
YEARS ENDED JUNE 30, 1986 AND 1987

MARCH 1988



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STATE OF CALIFORNIA
Office of the Auditor General

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Thomas W. Hayes
Auditor General

March 24, 1988

F-740

Honorable Bruce Bronzan, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 448
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its financial audit report of the California Student Aid Commission's (commission) State Guaranteed Loan Reserve Fund (fund) for the years ended June 30, 1986 and 1987.

The report shows that the loan defaults during fiscal year 1986-87 totalled \$137.1 million. The federal government purchased \$133.1 million of that amount under a reinsurance agreement; as a result, the fund had to absorb \$4.0 million of the defaults. In fiscal year 1985-86, the amount of defaulted loans was \$168.2 million, and the fund had to absorb \$12.0 million of the defaults.

Although the amount of defaulted loans decreased in fiscal year 1986-87, the cumulative rate of defaulted loans increased slightly to approximately 17 percent at June 30, 1987. The improved default experience should be reflected in the cumulative rate of defaulted loans in future years. Nevertheless, a high default rate is inherent in the program since granting the loans is based on financial need rather than credit risk. However, on July 1, 1987, the commission began to charge loan premiums on the basis of the default experience of the institution that the student borrower is attending. The new policy is designed to enable the commission to continue guaranteeing loans made to students from institutions with a good default experience, and at the same time allow the commission to continue providing loan guarantees to students from institutions with a poorer default experience.

Respectfully submitted,

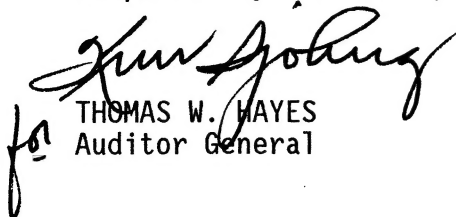

for THOMAS W. HAYES
Auditor General

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INTRODUCTION

We have conducted a financial audit of the California Student Aid Commission's State Guaranteed Loan Reserve Fund. The California Student Aid Commission (commission) requested this audit to meet its obligation to provide audited financial statements to lenders participating in the California Educational Loan Programs.

The State Guaranteed Loan Reserve Fund reflects the financial activities of three programs: the Guaranteed Loan Program, the State Guaranteed Loan Program, and the California Loans To Assist Students Program. Because the Guaranteed Loan Program has been replaced by the State Guaranteed Loan Program, the Guaranteed Loan Program no longer provides loans and contains only residual activity. The State Guaranteed Loan Program and the California Loans To Assist Students Program are collectively known as the California Educational Loan Programs.

In 1975, the State Guaranteed Loan Program was established and was later codified in Section 69760 et seq. of the California Education Code. In 1977, the Legislature added Section 69761.5 to the code to authorize the commission to serve as a guarantee agency for student loans. This program carries out the provisions of the federal Guaranteed Student Loan Program instituted within the federal Higher Education Act of 1965 and subsequent amendments. Also by authority of

Section 69760 of the California Education Code, the commission, in 1982, established the California Loans To Assist Students Program. The commission is responsible for guaranteeing federally reinsured loans issued to students and parents for postsecondary education expenses.

The commission has contracted with the Electronic Data Systems Corporation to provide administrative support services. These services include processing and approving all student loan applications, collecting insurance premiums, maintaining and managing the loan portfolio, processing claims from lenders, pursuing collections, and preparing reports required by the United States Department of Education.

The State Guaranteed Loan Reserve Fund is supported by federal funds, investment earnings, and insurance premiums paid by student borrowers.

We conducted this audit under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code.



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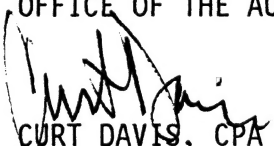
**Members of the Joint Legislative Audit Committee
State of California**

We have examined the balance sheets of the California Student Aid Commission's State Guaranteed Loan Reserve Fund as of June 30, 1986 and 1987, and the related statements of revenues, expenditures, and changes in fund balance for the years then ended. We made our examinations in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note 1, the financial statements present only the State Guaranteed Loan Reserve Fund. They are not intended to present the financial position of all funds and account groups of the California Student Aid Commission at June 30, 1986 and 1987, or the results of its operations for the years then ended, in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the financial position of the California Student Aid Commission's State Guaranteed Loan Reserve Fund at June 30, 1986 and 1987, and the results of its operations and the changes in fund balance for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

OFFICE OF THE AUDITOR GENERAL


CURT DAVIS, CPA
Deputy Auditor General

Date: January 13, 1988

Staff: Ulrich Pelz, CPA, Audit Manager
Denise L. Vose, CPA
Mary Bensorosky
Reed McDermott
Candace Tucker

**CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
BALANCE SHEET
AS OF JUNE 30, 1986 AND 1987**

	<u>1986</u>	<u>1987</u>
ASSETS		
Cash	\$ 686,456	\$ 1,278,897
Investments	119,246,818	142,092,715
Accounts receivable	919,014	978,813
Insurance premiums receivable	1,043,735	911,868
Due from other funds	68,520	188,266
Due from federal government	26,777,045	14,761,372
Equipment	<u>260,178</u>	<u>235,194</u>
Total Assets	<u>\$149,001,766</u>	<u>\$160,447,125</u>
LIABILITIES AND FUND EQUITY		
Liabilities		
Accounts payable	\$ 1,418,214	\$ 1,572,189
Payable to lenders and students	4,356,421	963,107
Due to other funds	383,437	278,614
Due to federal government	477,839	3,188,681
Liability for compensated absences	<u>91,548</u>	<u>109,255</u>
Total Liabilities	<u>6,727,459</u>	<u>6,111,846</u>
Fund Equity		
Investments in fixed assets	<u>260,178</u>	<u>235,194</u>
Fund balance		
Reserved for encumbrances	554,443	463,030
Reserved for loan defaults	52,735,507	62,473,826
Designated for federal advances	55,671,471	55,721,471
Undesignated	<u>33,052,708</u>	<u>35,441,758</u>
Total Fund Balance	<u>142,014,129</u>	<u>154,100,085</u>
Total Fund Equity	<u>142,274,307</u>	<u>154,335,279</u>
Total Liabilities and Fund Equity	<u>\$149,001,766</u>	<u>\$160,447,125</u>

See the notes accompanying the financial statements.

**CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
STATEMENT OF REVENUES, EXPENDITURES,
AND CHANGES IN FUND BALANCE
FOR THE FISCAL YEARS ENDED JUNE 30, 1986 AND 1987**

	<u>1986</u>	<u>1987</u>
Revenues		
Insurance premiums	\$ 17,321,673	\$ 11,435,619
Intergovernmental	11,787,143	4,696,937
Interest	8,238,575	9,391,649
Collection fees	7,338,499	11,415,597
Other	<u>23,494</u>	<u>9,680</u>
Total Revenues	<u>44,709,384</u>	<u>36,949,482</u>
Expenditures		
Personal services	1,449,260	1,774,207
Operating expenses and equipment	1,372,021	871,670
Department and state overhead	2,333,200	2,531,812
Contract and collection costs	12,220,964	15,773,666
State share of loan defaults	<u>12,010,193</u>	<u>3,962,171</u>
Total Expenditures	<u>29,385,638</u>	<u>24,913,526</u>
Excess of Revenues Over Expenditures	15,323,746	12,035,956
Other Financing Sources		
Federal advances	<u>41,287,723</u>	<u>50,000</u>
Excess of Revenues and Other Financing Sources Over Expenditures	56,611,469	12,085,956
Fund Balance, beginning of fiscal year	<u>85,402,660</u>	<u>142,014,129</u>
Fund Balance, end of fiscal year	<u>\$142,014,129</u>	<u>\$154,100,085</u>

See the notes accompanying the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. Definition of Reporting Entity

The accompanying financial statements reflect the financial position and results of operations of the State Guaranteed Loan Reserve Fund. This report does not include the financial activities of other funds and account groups accounted for at the California Student Aid Commission (commission).

The State Guaranteed Loan Reserve Fund accounts for the activities of the California Educational Loan Programs, which comprise the State Guaranteed Loan Program and the California Loans To Assist Students Program, plus the residual activities of the Guaranteed Loan Program, which ceased to provide loans in 1967.

2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the financial position and results of operations of the State Guaranteed Loan Reserve Fund of the commission. The financial statements have been prepared in conformity with generally accepted accounting principles applicable to state and local governments. Below is a summary of the more significant accounting policies.

A. Fund Accounting

The State Guaranteed Loan Reserve Fund is accounted for as an expendable trust fund. Expendable trust funds account for assets held in a trustee capacity, and both principal and income may be expended in the course of the fund's designated operations.

B. Basis of Accounting

The State Guaranteed Loan Reserve Fund is accounted for on the modified accrual basis. Under the modified accrual basis of accounting, revenues are recognized in the accounting period in which they become measurable and available, and expenditures are recognized, if measurable, in the accounting period in which the liability is incurred. The commission charges the costs of sick leave when this benefit is used rather than when it is earned.

3. Due From Other Funds

This account represents amounts due from the Personal Income Tax Fund for recoveries of defaulted loans collected by the Franchise Tax Board but not remitted to the State Guaranteed Loan Reserve Fund as of June 30.

4. Due From Federal Government

This account represents the June 30 balance due from the United States secretary of education for amounts billed that are to be reimbursed in the subsequent fiscal year. Included in this account are amounts due for administrative cost allowances and amounts billed for defaulted loans that the commission purchased under a federal reinsurance agreement. (See also Notes 15 and 18.) The following schedule summarizes the amounts due from the federal government as of June 30, 1986 and 1987:

	<u>1986</u>	<u>1987</u>
Administrative costs	\$11,787,143	\$ 4,566,090
Defaulted loans purchased	<u>14,989,902</u>	<u>10,195,282</u>
Total	<u>\$26,777,045</u>	<u>\$14,761,372</u>

In April 1986, federal legislation reinstituted the administrative cost allowance, which had been suspended since October 1, 1984. As a result, the amount due from the federal government at June 30, 1986, represents 21 months of administrative cost allowances while the amount due at June 30, 1987, represents only 9 months of administrative cost allowances.

5. Investments

This account represents the State Guaranteed Loan Reserve Fund's share of the State's Surplus Money Investment Fund, including \$4.0 million accrued interest. The stated amount is available upon demand.

6. Payable to Lenders and Students

This account represents amounts payable to lenders for the purchase of defaulted loans and amounts refundable to students. The following schedule summarizes the account balances at June 30, 1986 and 1987:

	<u>1986</u>	<u>1987</u>
Payable to lenders	\$4,329,470	\$908,882
Refundable to students	<u>26,951</u>	<u>54,225</u>
Total	<u>\$4,356,421</u>	<u>\$963,107</u>

The amount payable to lenders for the purchase of defaulted loans decreased in fiscal year 1986-87 because the commission experienced fewer delays in the purchasing and processing of defaulted loans.

7. Due to Federal Government

This account represents a reinsurance fee that the commission owes the federal government (see Note 15) and the federal share of collections on defaulted loans that the commission has not yet remitted.

8. Reserved for Encumbrances

This account represents goods and services ordered but not yet received by June 30.

9. Reserved for Loan Defaults

The California Administrative Code, Title V, Chapter 1, Part IV, Section 30108, requires the commission to maintain a reserve for the purchase of defaulted loans. The commission must deposit into this reserve at least 80 percent of the insurance premium revenue and the interest earnings from federal advances received under Section 422(c) of the Higher Education Act of 1965. Funds in this reserve may be used only for the purchase of defaulted loans.

10. Designated for Federal Advances

The United States secretary of education made advances to the commission to establish or strengthen the State Guaranteed Loan Reserve Fund. These advances may be used only to purchase defaulted loans. An agreement between the commission and the secretary also specifies that the secretary at any time may call upon the commission to repay part or all of any advanced monies when the secretary determines that the fund no longer needs the advanced monies (see note 19).

11. Lenders' Agreements

The commission's agreements with lending institutions require that the commission maintain a guarantee reserve fund. This fund must be represented by cash and marketable securities, and it must have a total market value of not less than one percent of the total amount of unpaid principal and interest of all approved notes that are covered by federal reinsurance under the agreement between the commission and the United States secretary of education. At June 30, 1987, the State Guaranteed Loan Reserve Fund had a balance in the Surplus Money Investment Fund of \$142.1 million (see note 5). This amount is readily available. Under the agreement with the lenders, the required balance was \$41.0 million at June 30, 1987, based on the amount of the original principal of

outstanding notes. The amount of the original principal does not reflect amounts paid on the notes, nor does it reflect unpaid interest, neither of which is reported to the commission.

In January 1983, the commission also entered into a guarantee reserve agreement with the California Student Loan Authority, which was established to provide a secondary market for loans to students and parents. This agreement requires that the commission maintain a fund balance reserved for loan defaults in the California Educational Loan Programs. This fund balance must be equal to at least one percent of the unpaid principal amount of all loans guaranteed by the commission. At June 30, 1987, the commission maintained a reserve for loan defaults of \$62.5 million. Under the agreement, the required reserve was \$41.6 million.

12. Retirement Commitments

Regular employees of the commission are members of the Public Employees' Retirement System (PERS), which is a defined benefit, contributory retirement plan. The amount that the commission and its employees contribute to the PERS is determined actuarially under a program in which contributions plus retirement system earnings provide the necessary funds to pay retirement costs as they are accrued. The State Guaranteed Loan Reserve Fund's share of retirement contributions for the fiscal years ended June 30, 1986 and 1987, was \$182,777 and \$203,825, respectively.

13. Liability for Compensated Absences

This account represents the State Guaranteed Loan Reserve Fund's liability to employees for accumulated vacation and compensated time off. The liability does not include amounts for accumulated sick leave because employees cannot receive cash for sick-leave balances when they leave state service. Accumulated sick leave may be exchanged upon retirement for service credits in an employee's retirement account.

14. Insurance Premiums

At the time that the lending institutions disburse the student loans, they withhold an insurance premium that is equal to a base rate times the number of years until the repayment is expected to begin. Until June 30, 1986, the base rate was one percent of the loan. Beginning on July 1, 1986, the base rate was reduced to three quarters of one percent. The lenders remit the insurance premium to the commission, which must use at least 80 percent of the premiums to underwrite defaulted loans. The remainder may be used to cover costs that the commission incurs in administering the loan program.

15. Intergovernmental Revenue

This amount represents federally reimbursed administrative costs less a reinsurance fee that the federal government began to impose as of October 1, 1986. The administrative cost allowance is set at one percent of the loans guaranteed during the fiscal year. The reinsurance fee is set at one quarter of one percent of the loans guaranteed unless the amount of defaulted loans that the federal government purchased during a federal fiscal year reaches 5 percent of the amount of loans in repayment status at the end of the preceding federal fiscal year. If the percentage of defaulted loans exceeds 5 percent, the reinsurance fees increase to one half of one percent of the loans guaranteed during the federal fiscal year. The loan defaults are expected to exceed the 5 percent threshold every year in future fiscal years.

For the 1985 federal fiscal year, which began on October 1, 1984, the United States secretary of education suspended payment of administrative cost allowances. In April 1986, the United States Congress passed a supplemental appropriation bill that reinstated the payment of the administrative cost allowances retroactively to October 1, 1984. Because of the suspension of the payments in fiscal year 1984-85 and the subsequent retroactive reinstatement, the amount for fiscal year 1985-86 includes the administrative cost allowance of \$4,805,900 for the period of October 1, 1984, to June 30, 1985. The following schedule summarizes the amounts that comprise the intergovernmental revenue account balance:

	<u>1986</u>	<u>1987</u>
Administrative cost allowance	\$11,787,143	\$6,979,985
Reinsurance fee		<u>(2,283,046)</u>
Totals	<u>\$11,787,143</u>	<u>\$4,696,937</u>

16. Collection Fees

The federal government allows guarantee agencies to retain up to 30 percent of loan default recoveries for collection efforts.

17. Contract and Collection Costs

This amount represents payments to Electronic Data Systems Corporation for administrative support services and for collection costs on recoveries of defaulted loans. Under the contract with Electronic Data Systems Corporation, contract fees are calculated at various percentages of the loan amount, depending on whether the loan is classified as guaranteed during the month, as outstanding at the end of the month, or as a defaulted loan purchased during the month. In addition, contract costs include

payments for changes in the processing system that the commission requested. The total contract costs were \$4,475,220 and \$4,962,702 for the years ended June 30, 1986 and 1987, respectively. The remainder of each amount represents collection costs of \$7,745,744 and \$10,810,964, which were paid to the Electronic Data Systems Corporation for the years ended June 30, 1986 and 1987, respectively.

18. State Share of Loan Defaults

The agreements between the commission and the lenders participating in the loan program require that the commission purchase guaranteed loans that have been defaulted if the lender has exercised due diligence in making, servicing, and collecting the loan. Likewise, the agreement between the commission and the United States secretary of education requires the secretary to purchase from the commission a percentage of those defaulted loans that the commission purchases from the lenders. The percentage of defaulted loans that the secretary will purchase may vary. During each federal fiscal year, the federal government will purchase 100 percent of the amount of defaulted loans until the total amount of the defaulted loans purchased reaches 5 percent of the amount of loans in repayment status at the end of the preceding federal fiscal year. After the amount of defaulted loans purchased reaches 5 percent of the amount of loans that were in repayment, the federal government will purchase 90 percent of the amounts of defaulted loans. When the amount of the defaulted loans purchased reaches 9 percent of the amount of loans that were in repayment, the federal government will purchase 80 percent of the amount of defaulted loans.

For the year ended June 30, 1987, the federal government purchased \$133.1 million of the \$137.1 million of defaulted loans. For the year ended June 30, 1986, the federal government purchased \$156.2 million of the \$168.2 million of net defaulted loans.

19. Subsequent Events

As of July 1, 1987, the commission changed its loan premium structure. The new premiums will range from zero to 3 percent of the loan amount, depending on the default experience of the institution that the borrower is attending. The effect of the change of the premium structure on the premium revenue is unknown.

In December 1987, the President of the United States signed legislation that will have a material effect on the amount of federal advances. Under this legislation, the commission will be required to return an estimated \$47.9 million of the \$55.7 million in federal advances by September 30, 1989. Although the return of the advances will have a significant effect on the fund balance and the interest revenue, the commission does not expect that this will affect its ability to maintain the required level of reserves (see notes 10 and 11).

OTHER COMMENTS

As an integral part of our examination, we reviewed the accounting procedures of the California Student Aid Commission and its related system of internal accounting control to the extent that we considered necessary to form an opinion on the fairness with which the financial statements of the State Guaranteed Loan Reserve Fund present the fund's financial position and the results of the operations in accordance with generally accepted accounting principles consistently applied. As part of our review, we are issuing a management letter to the commission suggesting action that it should take to improve its administration of the State Guaranteed Loan Reserve Fund.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps